Unintended Consequences

MARCH 2023

Amidst the recent reportage about the winnowing out of the UK stock market, I was particularly struck by William Hague's article in The Times in March. He somewhat shamefacedly quotes an expert on the pension industry who notes the UK has become "the only major economy where local pension funds have in effect abandoned investment in domestic companies."

Hague continues: "We should all hold our hands up, over successive governments, to adding new regulations or tax penalties to these funds. But no ministers ever intended that we would be down to only 4% of our pension assets invested in UK equities, from half 20 years ago."

That is indeed an unintended and possibly baleful consequence. The UK has the second largest pool of pension assets in the world, after the USA, with a value of £2.6 trillion reported in 2022. You must wonder how much future wealth might be created in the UK, if half of that capital was still invested in the UK stock market?

Now, let me be clear: I am sympathetic to pension fund trustees and consultants. They have a weighty responsibility for their beneficiaries and must invest rationally to achieve long-term goals. It is not the primary job of pension funds to bankroll the UK corporate sector, or, even, to back untested UK technology or business models (though these could be valuable secondary benefits). I also salute Lindsell Train Limited's (LTL) pension fund clients, indeed all our clients, who are steadfastly invested in our UK equity strategy. I hope my discussion below will reassure them they have made a wise allocation to some outstanding companies that just happen to have their primary stock market listing in London.

The sad fact is you can understand pension fund asset allocators' disenchantment with and disinvestment from UK equities. Investment strategist Robert Buckland wrote an excellent column about the UK stock market in the Financial Times in February. Like me, Buckland goes back a long way with UK equities and his piece reflected on their travails in recent decades. He noted that in 2000 the UK stock market accounted for 11% of the value of the MSCI World Index. Today it is down to 4%. Three UK companies were in the top 15 by global market capitalisation in 2000. Now the biggest – Shell – ranks only 38th.

There's no escaping that much of the UK stock market's loss of global status is the result of dismal capital performance. The close of the 20th century marked a temporary peak for the FT All Share Index, of 3,242. Depressingly, that historic level was revisited as recently as 2020 – admittedly in the grip of COVID. And in March 2023, the All Share is only c.33% higher than where it started the new millennium – a poor capital return for investors taking the risk of investing in UK companies over the best part of a quarter of a century. Of course, that capital return is sweetened by the ample dividend yield offered by the Index. But disappointed investors might argue that UK corporations' generosity with dividends has sometimes been at the expense of the building of long-term business value.

That last point is difficult to prove and, of course, there are circumstances when dividend payments are an efficient way of returning value. But even in LTL's very concentrated UK portfolios, there are several companies we believe would command higher share prices today if their boards had previously focussed on maximising organic business growth, rather than diverting cash flows to shareholder dividends (and rest assured, as investors looking to maximise long-term business value, we told them so).

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The UK's unwelcome reputation as a backwater in 21st century equity markets is symbolised by the absence in its upper echelons of globally significant technology champions. Now, it is easy and wrong to underestimate the expertise required to extract oil and minerals from the Earth. In this sense BP and RTZ are "technology" companies. And the UK's two pharma giants commit billions of R&D dollars to create proprietary products. But the lack of digital and software winners is evident and galling in the UK's top 10 market capitalisations. The example of Netherlands semiconductor equipment manufacturer, ASML's shares up 16-fold over the last decade and now commanding a market capitalisation 20% bigger than Shell's shows you don't have to be American or Asian to win in technology.

To be fair to the UK stock market, over time RELX, London Stock Exchange (LSEG) and Experian have grown to be the 11th, 13th and 21st biggest UK companies respectively (all major holdings in our UK strategy) and each have serious digital technology credentials. RELX equity is up just under 5-fold since 2000, while Experian and LSEG are up 4.5-fold and 20-fold respectively since listing in 2006 and 2001. Nonetheless, Google's parent Alphabet has a market value 20x greater than RELX' £48bn and it is this sort of incredible wealth creation that the UK stock market has missed out on.

So, who am I, or any commentator, to argue that UK pension funds made a historic mistake in running down their UK equity exposure? Indeed, perhaps they responded rationally to the lack of value-creating companies listed on the London stock market and have been wise to focus instead on more promising global stocks, or even Index-Linkers.

And, what's more – does pension fund disinvestment from UK equities really matter? Specifically, does it matter to other, continuing holders of UK equity assets, such as, for instance, the Lindsell Train UK equity strategy? Equity has to be owned by someone – for every seller there is a buyer. It is evident international investors have taken up the supply and they now make up over half the ownership of the UK market, a proportion that has nearly quintupled over 30 years (according to the valuable study produced by the Investor Forum in late 2022).

This increase in international ownership is by no means a bad thing. Perhaps smart global investors can help UK companies pursue growth strategies better than liability-haunted UK pension funds. For example, we are delighted to see that, according to Bloomberg, the 10th biggest shareholder in Diageo is now Warren Buffett's Berkshire Hathaway, having doubled its stake in recent months. A suitable investor, you would think, in one of the world's very best consumer brand companies. It is interesting too, that Bill Gates (or the Gates Foundation) is the 9th biggest shareholder in Diageo. Of course, Bill Gates will get to see and act on any number of new technology investment ideas, but you assume it is also a comfort for him to have some of his wealth committed to brands as enduring and ubiquitous as Johnnie Walker and Guinness. LTL is 8th. (Caveat: all the shareholding data above and below are taken from Bloomberg and we have known that data to be inaccurate or tardy on occasion.)

If we are right that RELX is one of the UK's most promising growth companies, indeed, one of the world's most promising growth companies, it is noteworthy that the biggest "active" investor in the company is Artisan Partners, a $138bn US-based global investment company. Artisan will be asking RELX the right questions about investing for growth, we are sure. LTL sits 6th on the register. The same is true for Experian, the world's biggest credit bureau, with most of its profits generated in the USA. I like the fact that Experian's 4th biggest shareholder is MFS, a venerable US institution; we are 8th here too. LSEG must be one of the most compelling growth stories listed on its own stock market. Given that, it is bemusing to see that Microsoft is a bigger investor in the LSEG than any UK institution, with a 4% holding, worth £1.6bn (after all, not a big number in the context of trillions of UK pension assets). But, from our clients' perspective, as the 6th biggest shareholder, we're happy that Microsoft is the 5th. It has credible plans to accelerate LSEG's growth that we will all benefit from.

Talking about unintended consequences. It is an unintended consequence of LTL's investment approach that we have become such major shareholders in the UK companies we have built our portfolios around. We are a top 10 "active" UK investor in FTSE 100 companies Burberry, Diageo, Experian, Hargreaves Lansdown, LSEG, RELX, Sage, Schroders and Unilever. Apparently, LTL has been on the other side of the trade. As pension funds have reduced their exposure to these fine companies, we have helped take up the slack.

Looking ahead, we hope that our focus on "big" UK companies may be a useful performance generator and differentiator. Anecdotally, those UK institutions that do invest in the domestic market tend to favour small and midcap UK companies, with the intention of delivering outsize "growth" for their portfolios. That "growth" is not necessarily delivered; it being notoriously difficult for medium-sized companies to become big companies. While big companies often continue to exploit the competitive advantages that made them so for far longer than investors expect.

That UK institutional predilection for midcaps is confirmed by the work done by the Investor Forum mentioned above. In its analysis of the ownership of the FTSE 100, it discovered that UK "active" managers own a lowly 6.3% of the top quartile of the index, while they own c.15% of the bottom quartile of the FTSE. That preference and the now prevalence of international investors owning major UK companies, leaves LTL as the biggest UK active investor in five £24bn+ market capitalisation companies – Diageo, Experian, LSEG, RELX and Unilever. If the brands and franchises owned by these companies are of the calibre we believe them to be and their equity as undervalued, then we are going to capture an outsize share of their future share price gains, compared to other UK institutions. I hope that will be our clients' reward for their patient ownership of outstanding companies listed on an out of favour stock market.

By the way, when you discuss business prospects with Ivan Menezes at Diageo, Erik Engstrom at RELX, Brian Cassin at Experian, David Schwimmer at LSEG and Alan Jope at Unilever you realise these are not "big" companies – in the sense of mature and cumbersome. They, and we, prefer to see them as "young" companies with their best decades of growth ahead of them. With global and digital opportunities to exploit, Big can be the new Small.

I conclude by claiming things aren't as bad for the UK economy and stock market as the pessimists hold. Consider: for all the negativity about the lack of innovation and productivity growth, the UK has the highest proportion of online shoppers in Europe compared to population, nearly double that of the French, who are the second most tech-savvy nation. 60% of that UK online shopping is conducted on mobile devices too – again the highest proportion in Europe. We are still a nation of shoppers, and retail website keepers. A survey sponsored by our portfolio holding, Sage, entitled "Digital Britain" estimates that untapped technology adoption could boost the UK economy by £232bn annually, if the productivity-boosting technology is adopted. Let's hope that report has been heard, read, marked, learned, and inwardly digested at Westminster. Brits also sustain an entrepreneurial spirit: at least as measured by company incorporations. There were over 800,000 new ones in 2022, up nearly 5% on 2021 and the more than 5 million extant companies in the UK today is 50% higher than in 2000 and 40% of them were established in the last 4 years. And think about the British appetite for risk-taking. The Gambling Commission notes that 44% of the adult population gambled on something in the month before December 2022. And, according to Bloomberg, the UK is the biggest online gambling market in the world. That's an unwelcome status, but it is indicative of a willingness to take a tech-assisted punt. It'd be great if, instead of speculating on the number of corners in a football match, UK punters were betting on the success of job and wealth creating companies. Although perhaps they are: monthly share trades on Hargreaves Lansdown's platform ran at c.400,000 pre-COVID. They peaked during the pandemic at 865,000 and, admittedly, have subsequently subsided to 664,000 monthly. But that is still up 66% since 2019. UK private investors are evidently willing to have a go, if presented with promising opportunities. Let's hope the corporate sector can oblige and that the next wave of British ingenuity will create another ARM, or even a UK Google.

But in the end, I am not a policymaker, nor am I even particularly interested in public policy (Sorry: I am just fascinated by companies and their ability to create long term wealth. That's my focus). But if you did ask what message I'd have for British policymakers today I'd remind them of Adam Smith's famous prescription for prosperity:

"Little else is requisite to carry a state to the highest degree of opulence…but peace, easy taxes and a tolerable administration of justice; all the rest being brought about by the normal course of things."

Nick Train, Portfolio Manager - March 2023

Source:
'An aversion to risk is holding Britain back', William Hague, *The Times*, 6 March 2023.
'LDI broke the UK stock market', Robert Buckland, *The Financial Times*, 14 February 2023.

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